Petition

81-893

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In The

Supreme Court of the United States

OCTOBER TERM, 1981

No. .....

LILLIAN BLANCHE BRENT and PHILLIP THOMPSON, Individually and as Trustees of the Mrs. Georgie Thompson Trust No. 1 (created by the will of Georgie E. Thompson, deceased); FRANCES DIANE NEAL and THE AMERICAN NATIONAL BANK, Independent Executors of the Estate of Terry Thompson, Jr.; ROBERT PRICE BRENT, III, and J. PHILLIP BRENT; and LILLIAN BLANCHE BRENT and PHILLIP THOMPSON, as Trustees for the Terry Thompson Children's Trust and the Terry Thompson Grandchildren's Trust,
Petitioners,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,
Respondent

and

No. .....

J. M. HAWLEY, Independent Executor and Trustee of the Estate of W. H. Taylor, Deceased,
Petitioner,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,
Respondent.

CONSOLIDATED PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Oct. 19, 1981

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QUESTION PRESENTED FOR REVIEW

Whether the United States Court of Appeals for the Fifth Circuit correctly applied Texas law in a diversity case brought to recover gas royalties under a "market value" lease, by its holding that market value at the well of natural gas sold in interstate commerce was equivalent to the Federal Power Commission area rate governing that vintage gas.

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CONSOLIDATED PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To The Honorable Chief Justice And Associate Justices Of The Supreme Court Of The United States:

The Petitioners, Lillian Blanche Brent, et al., and

J. M. Hawley, Independent Executor, bring this consolidated petition that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on October 2, 1980.

OPINION BELOW

The opinion of the court of appeals is reported at 626 F.2d 1261 (5th Cir. 1980). The opinion for the District Court for the Northern District of Texas is reported at 457 F.Supp. 155 (N.D. Tex. 1978).

JUDGMENT

The Judgment of the Court of Appeals for the Fifth Circuit was entered on October 2, 1980. A timely petition for rehearing *en banc* was denied on July 23, 1981, and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) and this petition presents an important question under Rule 19(1)(b) of the Rules of the United States Supreme Court.

STATEMENT OF THE CASE

Petitioners filed their suits on October 21, 1975, in the state court and the Respondent removed these suits on November 17, 1975, to the United States District Court for the Northern District of Texas, Amarillo Division, pursuant to the provisions of 28 U.S.C. § 1332, as

amended, and 28 U.S.C. § 1441. Petitioners in both cases are royalty owners under leases executed by their successors in interest under which Respondent produces from their lands natural gas which it transports in interstate commerce to ultimate distributors and burner-tip customers from the Texas Panhandle to Chicago. These leases obligate Respondent to pay the Petitioners a stipulated royalty of "the market value at the well of one-eighth (1/8) of the gas produced, saved and sold or used off the leased premises." Petitioners sued for the difference between the royalty actually paid and the amounts claimed due under the market value provision of the oil gas leases. These cases were consolidated for trial, and consolidated upon appeal.

To prove the "market value at the well of one-eighth (1/8) of the gas" the Petitioners relied upon the testimony of two expert witnesses who utilized both interstate and intrastate contracts of sale of gas of similar quality within the geographical area executed contemporaneously with the production and taking of the gas in controversy. In defending the suit, the Respondent utilized an expert witness who did not examine actual contracts, but relied on an F.P.C. area rate which embodied two distinct tiers of prices for gas of the same vintage as the gas in controversy, and asserted that the market value at the well of gas sold into interstate commerce was necessarily the lower tier of the F.P.C. area rate governing that gas. Petitioners also proved that the Respondent paid royalty for each 1,000 cubic feet of gas extracted from their lands, but reported the production and sold it upon the basis of its Btu content. (S.F. 9-15). By accounting on a cubic foot

basis to the royalty owners, and by selling upon a heating value basis, the Respondent reaped a substantial profit without having to pay Petitioners their share of that profit. This substantial profit had a direct relationship to the market value at the well of the gas in question, but was not accounted for to the Petitioners.

The net result of the trial court's judgment and the affirmance by the Fifth Circuit was that an F.P.C. area rate governing the vintage gas in controversy determines its market value at the well for the purposes of paying royalty. The trial court and the Fifth Circuit did not speak to Btu adjustment, or the use of comparable sales of interstate gas of the same vintage as that in question as a basis for determining royalty, although two important state decisions were rendered between the time the Fifth Circuit issued its opinion and denied the petition for rehearing *en banc*. These two state court decisions, issued by the Texas Supreme Court, present a clear conflict with the opinion of the Fifth Circuit appealed from by this petition.

REASONS FOR GRANTING THE WRIT

1. The decision below conflicts with the decision of the highest state court on exactly the same point.

Erie Railroad Co. v. Tompkins, 304 U.S. 64, 82 L.Ed. 1188, 58 S.Ct. 817 (1938) provides the ultimate legitimacy for federal decisions which accurately track state law. As the Fifth Circuit noted in *Duke v. Sun Oil Co.*, 320 F.2d 853 (5th Cir. 1963):

> At the outset it is good to re-emphasize that under *Erie* we are sitting as a Texas court applying Texas law as best we can devine it * * * It is thus

> encumbent upon us to apply the principles, fashioned by the Texas courts, of oil and gas law to the facts of this case.

Id. at 858. The facts of this case are nearly identical to the facts in *First National Bank in Weatherford v. Exxon Corp.*, 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980). The court below failed to follow state law enunciated in this case in two important respects: (1) it adopted as a basic legal premise underlying its decision that all comparable sales of interstate gas used as a collective measure of market value at the well of the gas in controversy would have to be made at a price exactly equal to the F.P.C. rate applicable to the gas in controversy and (2) in adopting an F.P.C. area rate as market value for the gas in controversy, it approved use of a rate arbitrarily selected by Respondent rather than a rate at which comparable sales would have been made in the time periods in which the market value at the well of the gas in controversy had to be determined.

a. The Texas Court of Civil Appeals in the *Weatherford* case adopted the conclusion of law of the trial court that:

> [T]he only gas sales which may be comparable to the sale involved in this case are sales to the interstate market of gas of the same vintage as the gas involved in this case made by a similar producer. All other sales, and specifically intrastate sales, are not comparable to the sale involved in this case and are therefore not relevant to the market price of the gas involved in this case.

Id. at 789. Upon appeal of this decision to the Texas Supreme Court, that court approved the decision and noted that the question of how market value of gas was

to be determined had received a similar answer in *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981). The court stressed sales comparable in quality as well as time of delivery of the gas in question. However, the court distinguished intrastate from interstate sales, denominating the latter as a different legal quality. Because of this, intrastate sales of gas were not comparable for the purposes of determining the market value of interstate gas. The Texas Supreme Court did not hold that the market value at the well of gas sold in interstate commerce was the F.P.C. area rate governing that particular gas at that particular time. The net effect of the Fifth Circuit's decision in this case is that the F.P.C. area rate governing the gas in question constitutes market value for the purpose of calculating royalty. This holding is incompatible with the law set out in *Weatherford* and in *Middleton* that in a private contractual dispute between a royalty owner and producer under a "market value" lease, royalty is to be determined by evaluating comparable sales of the same vintage gas into interstate commerce which are evidenced by contracts executed at or near the time the gas in controversy is produced from the ground. In the *Weatherford* case, the testimony received by the court was that of the witness who examined sales made contemporaneously with the delivery of the gas in question, sales made into the interstate market. Mr. Frank C. Bolton, Jr., testified as an expert witness for Exxon. He concluded that the only comparable sales were those of gas in the interstate market and of the same vintage as the gas involved in this case. He used four comparable sales and derived at a weighted average price ranging from 14.4¢ in March,

1974, to 22.6¢ in April, 1979. This methodology, adopted by the court of civil appeals and approved by the Texas Supreme Court, involves the sifting of interstate contracts of the same vintage gas, not the blind application of a particular area rate to the gas in controversy. The Texas Supreme Court noted in *Weatherford* that it had answered the difficult question of how the market value of gas was to be determined in *Exxon Corp. v. Middleton,* 613 S.W.2d 240 (Tex. 1981). In *Middleton* the court flatly stated that "sales comparable in time occur under contracts executed contemporaneously with the sale of the gas in question". *Id.* at 247.

Neither *Weatherford* nor *Middleton* were available to guide the Petitioners at the trial of this case. Petitioners relied solely upon *J. M. Huber Corp. v. Denman,* 367 F.2d 104 (5th Cir. 1966) and *Weymouth v. Colorado Interstate Gas Co.,* 367 F.2d 84 (5th Cir. 1966) and, of course, *Texas Oil & Gas Corp. v. Vela,* 427 S.W.2d 866 (Tex. 1968). These were the stellar landmarks in the constellation of market value litigation. Instead of reversing and remanding Petitioners for failing to follow the dictates of the Texas Supreme Court in *Middleton* and *Weatherford,* both of which were decided while this case was on appeal to the Fifth Circuit, that appellate court adopted its own legal standard for determination decision below. It is not only this case which veers in an erroneous direction by reason of the decision below, but all subsequent cases filed in the various jurisdictions under Fifth Circuit review. For these reasons this case should be reversed and remanded.

b. Even if Texas law were that F.P.C. area rates govern market value of a particular vintage gas for pur-

poses of paying royalty, the Respondent used the wrong rate and the Fifth Circuit took no notice of that point. Ignoring state law is as erroneous as misconstructing it. For a period of time involved in this controversy the Respondent utilized an area rate adopted from Opinion 586 in F.P.C. Docket No. AR64-1 entitled "Area Rate Proceeding, et al. (Hugoton-Anadarko area)" 44 F.P.C. 761 (1970) *aff'd California v. Federal Power Commission*, 466 F.2d 974 (9th Cir. 1972), aff'd sub nom. *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283, 41 L.Ed.2d 72, 94 S.Ct. 2328 (1974). The two salient features of the order are: (1) it sets prices applicable only to gas sold pursuant to contracts, and (2) the contracts are divided into two groups, those dated prior to November 1, 1969 and those dated afterward. The Respondent is a pipeline company which does not sell the gas in controversy pursuant to contract. The Respondent could have, at any time after November 1, 1969, sold this gas by contract if it chose, triggering the second, higher tier of prices. Those two tiers are as follows:

(i) For all gas produced in the Panhandle and Hugoton Fields:

(aa) Prior to July 1, 1972:
12.50 cents in Kansas
13.25 cents in Oklahoma
13.50 cents in Texas

(bb) On and after July 1, 1972:
13.50 cents in Kansas
14.25 cents in Oklahoma
14.50 cents in Texas

(ii) For all gas produced from fields or reservoirs other than the Panhandle and Hugoton Fields:

(aa) Prior to July 1, 1972:
17.50 cents in Kansas
18.50 cents in Oklahoma
19.00 cents in Texas

(bb) On and after July 1, 1972:
18.50 cents in Kansas
19.50 cents in Oklahoma
20.00 cents in Texas

(2) Gas sold under contracts dated on or after November 1, 1969.

(i) Gas well gas:

(aa) Prior to July 1, 1972:
19.0 cents in Kansas
20.0 cents in Oklahoma
20.5 cents in Texas

(bb) On and after July 1, 1972:
20.0 cents in Kansas
21.0 cents in Oklahoma
21.5 cents in Texas

(ii) Casinghead gas:

(aa) 17.5 cents in Kansas
18.5 cents in Oklahoma
19.0 cents in Texas

(bb) On and after July 1, 1972:
18.5 cents in Kansas
19.5 cents in Oklahoma
20.0 cents in Texas

It was stipulated that the defendant utilize the following prices set out in that area rate order:

July 1, 1971
to July 1, 1972 ..... 13.5¢ per mcf
July 1, 1972
to January 1, 1976 ..... 14.5¢ per mcf

(ROA at 241, ROA at 182). These prices were arbitrarily selected by Respondent as a basis upon which to pay royalty.

The gas sold under contracts dated prior to November 1, 1969, are entitled to the lower tier price. But gas sold under contracts executed after that date are entitled to the higher tier of prices. That the Respondent never chose to sell the gas in controversy, but instead transported it by pipeline from the Texas Panhandle to points along its pipeline to Chicago, is irrevelant. The test is comparable sales and this vintage gas was being sold under the second, higher tier during the periods in controversy. Thus, even if the Fifth Circuit was correct in adopting as a basic legal premise underlying its decision the rule that all comparable sales of interstate gas used as a collective measure of market value at the well of gas in controversy must be made at the same price under the same F.P.C. rate, the higher tier should have been the rate governing the disposition of this case. That higher tier should have established the market value of this gas for royalty purposes.

Although mere pennies per mcf are involved in this case, the volume of gas involved makes the point exceedingly important. Again we say that if a particular area rate governs a particular vintage of gas, it is only logical that comparable sales of that vintage gas into interstate commerce will be made within that price range. Restricting the Petitioner to a lower tier of prices arbitrarily selected by the Respondent for calculating its royalty payments is not only manifestly unfair, but it does not at all comport with the thrust of the two major Texas decisions directly governing the disposition of

this case. That the point was not mentioned by the Fifth Circuit only adds insult to financial injury of the Petitioners.

2. The importance of this case lies in its impact upon subsequent cases within the jurisdiction.

The disposition by the Fifth Circuit of this case, and the opinions in *Weatherford* and *Middleton,* do not put to rest the continuing controversy generated by "market value" royalty provisions in oil and gas leases, especially in an era of expanded exploration and production and escalating gas prices. Because these cases often involve diversity jurisdiction, the very district court from which this case emanates will be called upon to sit in judgment of numerous subsequent cases involving exactly the same fact situation and legal principles. The other federal jurisdictions within Texas will also be called upon to answer these questions. The harm visited upon the Petitioners by the incorrect ruling of the Fifth Circuit in this case can only serve as harm to other plaintiffs under the same precedent.

For example, in a lawsuit between the same parties filed in the same court for market value royalties due subsequent to the time frame involved in this case, plaintiffs base their cause of action upon the Texas Supreme Court's statement in *Weatherford* that *Middleton's* comparable sales test will be utilized even though intrastate sales are not comparable for the purposes of determining market value at the well of gas sold into interstate commerce. Accordingly, plaintiffs seek to discover contracts of sale or purchase executed during the time periods in controversy by the defendent (the Respondent here) for interstate gas. The defendents

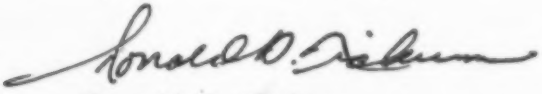
resist discovery with an objection to production of the documents based on the fact that they are irrelevant, because the market value of the gas involved in this case is equivalent to the F.P.C. rate applicable to the gas upon the date it was produced.

It is apparent that this type of affirmative defense and argument has not been put to rest by the Fifth Circuit's decision and will recur in the numerous market value cases that presently pend in various federal jurisdictions of Texas. Perhaps the Texas Supreme Court will have to write again on the subject to clarify its remarks in *Weatherford* and *Middleton,* but until that time the Fifth Circuit's decision in this case appears patently erroneous and the precedent that it sets eventually must be overturned. In the meantime, the decision visits harm upon all litigants situated similarly to Petitioners.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Fifth Circuit.

Respectfully submitted,



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October 19, 1981

APPENDIX

Lillian Blanche BRENT, Frances Diane Neal and the American National Bank, Executors of the Estate of Terry Thompson, Jr., and Phillip Thompson, Individually and as Trustees,

Plaintiffs,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Defendant.

J. M. HAWLEY, Independent Executor & Trustee of the Estate of W. H. Taylor, Deceased,

Plaintiff,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Defendant.

Civ. A. No. 2-75-167, 2-75-168.

United States District Court,
N.D. Texas,
Amarillo Division.

Aug. 2, 1978.
Supplemental Opinion Sept. 13, 1978.

Owners of royalty payable under certain gas leases brought suit against producer of natural gas from lands encompassed by the leases, contending that they had been underpaid and seeking to recover the amount of underpayment plus prejudgment interest. The District Court, Woodward, Chief Judge, held that: (1) the Federal Power commission did not have primary jurisdiction over the question of royalty prices; (2) the controversy concerning the amount of royalties payable to royalty

owners was for the federal district court and not for the FPC; (3) there had been no waiver, ratification, estoppel or accord and satisfaction that would bar the royalty owner's recovery; (4) where the gas involved in the dispute had been irrevocably dedicated to interstate commerce, only interstate gas sales in the relevant geographical area, made by producers of the same classification as defendant and involving gas of the same vintage, were comparable sales that could be used to determine the "market value" of the gas; (5) an examination of the comparable sales revealed that the market value of the gas in question was the stipulated Federal Power Commission applicable area rates, adjusted by specific provisions contained in various FPC orders, and (6) where the gas leases contained market value royalty clauses, the royalty owners were entitled to royalties based on the market value determined by such FPC applicable area rates after the required adjustments.

Ordered in accordance with opinion.

1. Gas 1

Where parties to controversy concerning amount of royalties payable under gas leases had stipulated that the defendant producer was a natural gas company as defined by the Natural Gas Act and that the gas produced from the subject leases was transported and sold in interstate commerce and had been irrevocably dedicated to the interstate gas market, the gas and the sale thereof by the defendant to its interstate purchaser was subject to the regulation and control of the Federal Power Commission. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

2. Mines and Minerals 79.3

Controversy concerning the amount of royalties payable to royalty owners under certain gas leases was to be determined by federal district court and not by the Federal Power Commission.

3. Mines and Minerals 79.3

Where, contrary to the provisions of gas division orders between owners of royalty and producer, specific payments had not been made in the amounts called for and where, for the period involved in litigation, the producer had never paid the exact amount called for in the gas division orders but had in fact paid a much higher royalty, the provision of the gas division orders that the royalty interest was to be paid at the rate of one-eighth of five cents per thousand cubic feet did not bar recovery in suit wherein owners of royalty contended that they had been underpaid.

4. Mines and Minerals 79.3

Where royalty changes were effected by notification of the change given owners of the royalty by the producer and where such changes were accepted by the royalty owners' acquiesence thereto, gas royalty division orders governing the amount per thousand cubic feet to be paid to the royalty owners were terminated, abandoned and rescinded by the course of conduct of the parties.

5. Mines and Minerals 79.7

In suit wherein owners of royalty payable under certain gas leases contended that they had been underpaid and sought recovery for such underpayment plus prejudgment interest, circumstances established that there was no waiver, ratification, estoppel or accord and satisfaction that would bar the royalty owners' recovery.

6. Mines and Minerals 79.3

Producer of gas from lands encompassed by gas leases was not entitled to any offset for amounts paid in excess of specific royalty amounts called for in gas division orders between the producer and the royalty owners where the producer had periodically altered the royalty paid so as to pay more than the amount called for in the division orders and where the royalty owners, by accepting the same, had effectively cancelled the prior royalty arrangement.

7. Mines and Minerals 79.3

Where gas leases contained royalty clause providing that the royalty was to be based on the "market value" at the well of one eighth of the gas produced, saved and sold, producer's obligation under the royalty clause was to pay royalties based on an amount representative of the "market value" of the gas being produced and not merely on what the producer received for the gas.

8. Mines and Minerals 79.3

In implementing test for "market value" of interstate gas pursuant to which the "market value" is what a willing seller and a willing buyer would agree to take and pay, the "market value" of gas is to be determined by sales of gas comparable in time, quality and availability of marketing outlets.

See publication Words and Phrases for other judicial constructions and definitions.

9. Evidence 142(1)

Only sales of interstate gas were "comparable sales" for purposes of determining the market value of gas that was irrevocably dedicated to the interstate market.

See publication Words and Phrases for other judicial constructions and definitions.

10. Mines and Minerals 79.3

"Market value" of gas that was irrevocably dedicated to interstate market was the Federal Power Commission area rates established for the geographical area in which the wells producing the gas were located.

11. Evidence 142(1)

Where many of the interstate gas sales contracts examined and considered by royalty owners' witnesses reflected prices that were short term or emergency sales prices, small producer prices, prices allowed for newly discovered gas and prices that were rolled back to the Federal Power Commission rate, such interstate sales contracts were not "comparable sales" for purpose of determining the market value of vintage gas in a situation involving a large producer and where there were no special exceptions supporting a petition to the FPC for higher rates.

12. Mines and Minerals 79.3

Owners of royalty payable under gas leases could not expect the royalty obligation existing under the leases to be determined free of rules and restrictions that attach to the market and the commodity to which such leases are applicable.

13. Gas 1

Federal Power Commission jurisdiction extends to gas dedicated to interstate commerce even though such jurisdiction and the right to regulate thereunder may drastically alter the private rights of individual parties having an interest in such gas.

14. Gas 1

Federal Power Commission jurisdiction over interstate gas may alter the private rights of parties not subject to that jurisdiction to the extent that such jurisdiction may limit the scope of sales that can be considered in determining the market value of interstate gas.

15. Evidence 142(1)

Where gas involved in controversy concerning amount of royalties payable under gas leases was irrevocably dedicated to the interstate market, only interstate gas sales in the relevant geographical area, made by producers of the same classification as the subject producer and involving gas of the same vintage as the gas in question, were "comparable sales" that could be used to determine the market value of the subject gas.

16. Mines and Minerals 79.3

Where examination of comparable sales revealed that the market value of gas that was involved in royalty controversy was the stipulated Federal Power Commission applicable area rates after said rates were adjusted by specific provisions contained in various applicable orders, owners of royalty payable under gas leases containing market value royalty clauses were entitled to royalties based on the market value determined by such rates after the required adjustments.

Howard F. Saunders, Sanders, Saunders, Brian, Finney & Thomas, Ronald D. Nickum, Amarillo, Tex., for plaintiffs.

Dennis M. Dylewski, Dyche & Wright, James T. Wright, John L. Verner, Houston, Tex., H. A. Berry, Underwood, Wilson, Sutton, Berry, Stein & Johnson, Amarillo, Tex., for defendant.

MEMORANDUM OPINION

WOODWARD, Chief Judge.

These cases were heard before the court, without a jury on the 20th and following days of June, 1977. After hearing and considering the evidence and the argument and briefs of all parties the court filed a memorandum opinion and additional findings of fact and conclusions of law on September 20, 1977 in each case. Subsequently plaintiffs filed motions to vacate and substitute findings of fact and conclusions of law contained within the above mentioned memorandum opinions. After considering said motions, the briefs filed in support of same and in opposition thereto, arguments of counsel, and after reconsidering the evidence and applicable case law, the court hereby withdraws its prior memorandum opinions and files this memorandum which shall constitute its findings of fact and conclusions of law in each case.

Plantiffs and intervenors (hereinafter referred to as plaintiffs) are the owners of the royalty payable under certain gas leases covering lands situated in Moore County, Texas (Stipulation No. 3 and the Exhibit referred to therein). The leases were originally executed in the period from 1926 to 1929 and were later amended in 1934 and 1940, but these amendments are not relevant to the controversy before the court. The defendant is the successor in interest to the original lessees and is the producer of the natural gas from the lands encompassed by the leases. Defendant transports all the gas produced from said leases outside the State of Texas.

By stipulation in the Pre-Trial Order (No. 4) it was agreed that each of the leases contained the following clause pertaining to the payment of royalty to lessors on the gas produced and sold or used off of the leased premises:

> "the market value at the well of one-eighth (⅛) of the gas produced, saved, and sold or used off the leased premises."

Defendant has paid to plaintiffs a royalty which in recent periods has been based solely upon the price approved by the Federal Power Commission (FPC) in connection with a certificate of convenience and necessity authorizing the interstate transportation and sale of the gas in question. Plaintiffs contend that they have been underpaid, that is, the market value of the gas (upon which their royalty is based) is greater than the FPC controlled price, and their prayer is for recovery of this difference plus pre-judgment interest.

[1] The parties have stipulated that Natural Gas Pipeline Company of America, defendant, is a natural gas company as defined by the Natural Gas Act, 15 U.S.C. § 717, *et seq.*, and that the gas produced from the subject leases and relevant to this case is transported and sold in interstate commerce and has been irrevocably dedicated to the interstate gas market. Accordingly, this gas and the sale thereof by the defendant to its interstate purchaser is subject to the regulation and control of the FPC.

Jurisdiction of the parties and subject matter of this controversy is vested in this court pursuant to 18 U.S.C. § 1332. The amount in controversy exceeds $10,000.00

and there is no dispute about the fact of complete diversity.

[2] The defendant, by motion, has contended that the FPC has primary jurisdiction over the question of royalty prices and that this court should not determine the controversy here involved. This motion has heretofore been overruled. It was and is the opinion of this court that the FPC does not have such jurisdiction and that royalty owners are not engaged in the sale of natural gas within the meaning of the Natural Gas Act, *supra*. *Mobil Oil Corporation v. Federal Power Commission*, 149 U.S. App. D.C. 310, 317, 463 F.2d 256, 263 (1972), *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676. This is a controversy concerning the amount of royalties payable to royalty owners which must be determined by this court rather than by the FPC.

The plaintiffs in this case are claiming additional royalty payments from November 1, 1971 to date of judgment, recognizing that any claim prior to that date would be barred by limitations. The intervenors pray for additional royalty payments for the period beginning April 1, 1973.

Before a determination is made as to the "market value" of the gas in question, upon which plaintiffs' royalty is based, it is necessary to determine the validity of defendant's affirmative defenses of estoppel, waiver, ratification, accord and satisfaction and a claim of offset.

[3] Defendant argues that the following provisions contained in some of the gas division orders between

plaintiffs and defendant completely bar any recovery in this case: (Pltf. Hawley Exs. 2 and 3)

> "Such royalty interest shall be paid to the royalty owners . . . at the following rates to-wit: . . . and for the remaining life of their contract one-eighth (⅛) of five cents (5¢) per thousand cubic feet."
>
> "This division order _____ constitutes an amendment to such lease."

But contrary to the provisions of these gas division orders, the court finds that the specific payments "for the remaining life of this contract" were not made in the amounts called for. Periodically the defendant would alter the royalty paid per mcf (in each case it was raised above the amount called for in the division orders). For the period involved in this litigation the defendant has never paid the exact amount called for in the gas division orders, but has in fact paid to the plaintiffs a much higher royalty.

[4]"The life of the contract," as referred to in these gas division orders, has expired and they are no longer effective so as to govern the amount per mcf to be paid to plaintiffs as royalty. When the royalty changes were effected by notification of the change given plaintiffs by the defendant (Pltf's Exs. 11, 12 and 13) and such changes were accepted by plaintiffs' acquiescence thereto, the gas royalty division orders were terminated, abandoned, and rescinded by the course of conduct of the parties. *Marsh v. Orville Carr Associates, Inc.*, 433 S.W.2d 928, 931 (Tex. Civ. App. — San Antonio, 1968 *writ ref. n.r.e.*).

[5, 6] It is concluded that there has been no waiver, ratification, estoppel or an accord and satisfaction that

would bar plaintiffs' recovery in this case. Defendant is not entitled to any offset for amounts paid in excess of the specific royalty amounts called for in the division orders as the act of defendant in raising the amount and the act of plaintiffs in accepting same effectively cancelled the prior royalty arrangment and the plaintiffs were not bound thereby.

Having determined that the affirmative defenses pled by defendant do not operate to bar plaintiffs' claims, nor does defendant's claim of overpayment entitle it to any offset, the court now turns to the issue of whether defendant has met its obligation under the "market value" royalty clauses by paying royalties based on prices equal to, or higher than, the area rates established by the FPC for the geographical region where defendant's wells are located.

[7] In order for defendant to have met this obligation it is clear that the royalties paid to plaintiffs must have been based upon an amount representative of the "market value" of the gas being produced, and not merely upon what defendant received for the gas. *J. M. Huber Corporation v. Denman,* 367 F.2d 104 (5th Cir. 1966); *Texas Oil & Gas Corporation v. Vela,* 429 S.W. 2d 866 (Tex. 1968). Otherwise the royalty clause would be transformed to a "net proceeds" provision rather than a "market value" provision.

[8] The test for "market value" of interstate gas has been thusly stated:

> " . . . what would a willing seller and a willing buyer in a business which subjects them and the commodity to restrictions and regulation, including a commitment for a long period of time, agree to

> take and pay with a reasonable expectation that the FPC would approve the price (and price changes) and other terms and then issue the necessary certificate of public convenience." *Weymouth v. Colorado Interstate Gas Company*, 367 F.2d 84 (5th Cir. 1966).

In implementing the above test, "market value" of gas is to be determined by sales of gas comparable in time, quality and availability of marketing outlets. *Vela, supra,* at 872, citing *Phillips Petroleum Co. v. Byrum,* 155 F.2d 196 (5th Cir. 1946.)

Thus the issue before this court, narrowly drawn is: What gas sales are comparable in determining the market value of the gas in question given the fact that such gas has been irrevocably dedicated to interstate commerce?

Both parties urge that their respective expert(s) have complied with the *Weymouth* test, and also with the evidentiary guidelines of *Vela*, in formulating their opinions as to the "market value" of the gas during the relevant time periods in question.

Plaintiffs' experts, both highly qualified in the field, examined gas sales contracts of both intrastate sales and interstate sales which were executed during the time period in question to arrive at their opinion of "market value." It is urged that these are the only opinions which comply with the *Vela* evidentiary standard of comparability in terms of time, quality and availability of marketing outlets. Plaintiffs also urge their experts' opinions took into consideration the effects of FPC regulation, thus meeting the *Weymouth* test, because such regulatory effects were inherent in the prices of the contracts examined, that is, the buyers and

sellers of those contracts necessarily considered FPC regulation when arriving at the prices stated in such contracts.

Defendant's expert witness, Jack Baumel, gave two alternative opinions as to the market value of the gas in question. First, based on his perception that there are two distinct markets for natural gas in the geographical area in question, that is, the uncontrolled intrastate market and the controlled interstate market, he gave his opinion that the market value of the gas at issue was the FPC area rates established for the geographical area in which the wells producing such gas were located. He reasons that the only market available for gas irrevocably committed to interstate commerce is the controlled interstate market, therefore, absent special circumstances, the only price available for such gas is that received on interstate sales which is necessarily the established FPC area rate.

Alternatively, Baumel gave his opinion that the market value of the gas in question was the weighted average of prices received for all current sales of gas, both intrastate and interstate, in the applicable geographical area during the relevant time period.

[9] This court concludes, considering FPC regulation of interstate gas, that under the facts of the instant case only sales of interstate gas are comparable to determine the "market value" of the gas in question, and that sales of intrastate gas are not comparable to make such a determination. *Hemus & Company, et al. v. Hawkins, et. al.*, 452 F.Supp. 861 (S.D. Tex., decided June 20, 1978). There are two markets for gas, intrastate and interstate, but the only market for the gas in question in the instant

case is the interstate market.

[10] In view of this conclusion the court finds that Mr. Baumel's first opinion of "market value" is the only opinion which meets both the *Weymouth* and *Vela* standards, and therefore, is the opinion which correctly states the "market value" of the gas at issue.

[11] The opinion given by plaintiffs' expert witnesses must be rejected for two reasons. First, said opinions take into consideration both sales of intrastate and interstate gas in determining "market value." Secondly, it was shown that many of the interstate gas sales contracts examined and considered by plaintiffs' witnesses reflected prices which were short term or emergency sales prices, small producer prices, prices allowed for newly discovered gas and prices which were rolled back to the FPC rate. Under the facts of this case involving vintage gas, a large producer, and where no special exceptions were shown to exist which would support a petition by either plaintiffs or defendant to the FPC for higher rates, the court is of the opinion that many of the interstate sales contracts, upon which plaintiffs' market value opinion is based, are not comparable to determine market value.

Mr. Baumel's second opinion based upon the volume weighted average formula must also be rejected because it is founded upon consideration of both intrastate and interstate sales, and upon contracts which were entered into many years before the periods in question in this case.

Mr. Baumel's primary opinion meets the *Weymouth* test of market value in that it obviously takes into

consideration the facts of a regulated market and regulated commodity and also realistically sets forth the only price a willing buyer and willing seller could accept in the FPC controlled interstate market which is, absent special exceptions, the FPC applicable area rate. This opinion also satisfies the evidentiary standard of *Vela* in that when one considers sales of like gas, that is, of the same vintage, in a like market (interstate), during the relevant period, the only price which could be received for such gas, again absent some special exception, is the FPC established rate.

Therefore, the court concludes that the market value of the gas here in question is for the relevant period, the stipulated FPC area rates set forth in Stipulation No. 20 of the Pre-Trial Order (No. 4).

This conclusion is mandated by the test set forth in *Weymouth, supra,* and is supported by the *Hemus* case, *supra,* which is directly in point. Additionally, this result is not precluded by the decisions in *Vela, supra, J. M. Huber, supra, or Kingery v. Continental Oil Co.*, 434 F.Supp. 349 (W.D. Tex. 1977).

In *Vela* the Texas Supreme Court was concerned with determining the market value of intrastate gas committed to a long term contract. The court held that the lessee could not avoid its obligation to pay "market value" to the royalty owner merely because of its failure to protect itself from escalating prices. In *Vela* the court was not dealing with a commodity irrevocably committed to a regulated market and the opinion gives very little guidance as to what sales would be comparable in such a situation.

The *J. M. Huber* court phrased the question facing it as follows: "whether under the terms of the oil and gas lease from Lessors to Lessee-Producer the amount payable as royalty is to be fixed by the stated percentage (¼th of a.) the price received by Lessee from its Pipeline Purhcaser or b.) the market price for like gas in the field." The court held that under the terms of the lease, the agreement was not to pay one-fourth of the price received from the market on which the gas in question was sold, rather it was to pay one-fourth of the "market value" and that the terms of the pre-existing contract with the interstate pipeline company did not necessarily determine "market value." However, the question of "market value" was left open to be tried later.

This court is not holding that the defendant must pay royalties based solely on the price it receives for the gas, rather the holding is that the "market value" of the gas here in question, based on comparable sales in the interstate market, is the FPC area rate. The court recognizes that in reality the result may be the same, that is, what the defendant receives for its gas will likely be what the "market value" or FPC area rate is, but this result stems from the fact that the only comparable sales of gas are those made in the interstate market and not from the proposition that defendant need only pay royalty based on what it receives.

[12] In *Kingery v. Continental Oil Co.*, 434 F.Supp. 349 (W.D. Tex. 1977), the court in a case similar to the one at bar held that the plaintiff was not bound to accept royalties based on the FPC regulated price, when the lease provided for royalties based on "market value." The court in *Kingery, supra,* based its holding upon the

conclusion that plaintiffs did not necessarily contemplate that royalty rates would be affected by regulation of the FPC, because the leases involved in that case were executed prior to the decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 38 L.Ed. 1035 (1954), and prior to that decision no court had held that the Natural Gas Act gave the FPC authority to regulate contractual rates charged by producers selling gas to interstate pipelines. Although the leases in the instant case were executed far prior to the effective date of the Natural Gas Act or *Phillips, supra,* the court finds the decision in *California v. Southland Royalty Co.*, 436 U.S. 519, 98 S.Ct. 1955, 56 L.Ed.2d 505 (decided May 31, 1978), a compelling reason to disregard the proposition set forth in *Kingery*, that the plaintiffs could not and did not contemplate royalty rates would be affected by FPC regulation. Here as is the *Southland Royalty* case the plaintiffs were mineral lease owners who entered into a lease permitting the leaseholders to make interstate sales. They did not object when defendant sought to place the gas in interstate markets. As was said in *Southland Royalty, supra,* 98 S.Ct. at p. 1960: "Having authorized [defendant] to make interstate sales of gas, [plaintiffs] could not have expected those sales to be free from the rules and restrictions that from time to time would cover the interstate market." Similarly, plaintiffs here could not expect the royalty obligation existing under the lease to be determined free from the rules and restrictions which attach to the market and the commodity to which such leases are applicable.

[13, 14] Further, plaintiffs have strenuously argued

that the Natural Gas Act, effective subsequent to the date the leases here in question were executed, cannot alter the prior contracts of lease. *California v. Southland Royalty Co., supra,* makes it clear, however, that FPC jurisdiction does extend to gas dedicated to interstate commerce, even though such jurisdiction and the right to regulate thereunder may drastically alter the private rights of individual parties having an interest in such gas. Although *Southland Royalty Co.* is not directly in point, the reasoning of that opinion convinces this court that FPC jurisdiction over interstate gas may alter the private rights of parties not subject to that jurisdiction, to the extent that such jurisdiction may limit the scope of sales which can be considered in determining "market value" of interstate gas. Thus, as has already been pointed out, the only sales which can be considered comparable in determining "market value" of the gas in question are sales of like gas occurring in interstate commerce, and when only interstate sales are considered the only "market value" for the gas in question is the applicable FPC area rates.

Plaintiffs also seem to argue that the FPC area rates are stipulated to in the Pre-Trial Order (No. 4) do not necessarily limit the price which can be received for interstate gas similar to the gas involved in this case, and therefore, those rates should not constitute "market value" of the gas in issue. This argument is premised on the fact that since 1970 the FPC has issued various orders and opinions increasing the rates applicable to interstate gas in the geographical areas where defendant's wells are located. However, it appears to the court, after consideration of such orders and opinions,

that the stipulated rates are the only rates available for interstate gas of the same vintage as the gas herein involved, absent some special exception. There was no evidence that any grounds for a special exception existed in this case and no evidence that any interstate producers of the same size classification of defendant, located in the same geographical area as defendant's wells with gas of the same classification as the defendant's gas, were receiving prices in excess of the stipulated FPC applicable area rates, in the absence of some special exception.

[15, 16] In conclusion the court finds that there are two distinct markets for gas in the geographical area where defendant's wells are located, the interstate market and the intrastate market. The gas in this case has been irrevocably dedicated to the former. Therefore, only interstate gas sales in the relevant geographical area, made by producers of the same classification as defendant and involving gas of the same vintage as the gas in question, are comparable to determine the "market value" of the gas involved in this case. A comparison of these sales, as is evidenced by Mr. Baumel's primary opinion, reveals that "market value" of the gas in question is the stipulated FPC applicable area rates after said rates have been adjusted by specific provisions contained in various applicable orders of the FPC establishing such rates. Thus, plaintiffs are entitled to royalties based upon "market value" determined by such rates after said adjustments.

This opinion shall constitute the findings of fact and conclusions of law in each of the above cases and the Clerk is directed to file same in each case for such

purposes.

It is hereby ordered that counsel for all parties will confer and submit a proposed judgment in each case to the court on or before August 31, 1978, which judgments will be in accord with this opinion.

The Clerk will furnish a copy hereof to each attorney.

SUPPLEMENTAL OPINION

This memorandum opinion is written supplemental to the court's memorandum opinion of August 31, 1978 and in response to the motions for judgment made by each party and the letter-briefs in support thereof.

The court is of the opinion that the market value of the royalties, during the time in question, were those amounts as set forth in Stipulation No. 20 contained in the pre-trial order of this court and approved by all attorneys. The court further finds that these amounts have been paid by the defendant to the plaintiffs and that a take nothing judgment will be entered in each case.

The stipulation of the parties (Stipulation No. 20 in the Pre-Trial Order), and the plaintiffs' response to Interrogatory No. 2 establish the fact that the royalty rates paid plaintiffs during the period of time in question in this case are the same as the prices established for the sale of gas by major producers in interstate commerce as such rates are fixed by the Federal Power Commission.

The record does not contain any evidence that would support a finding that any other rate was applicable to the gas in question and, as found in the original

memorandum opinion of this court, the rates as shown in Stipulation No. 20 and the answer to Interrogatory No. 2 reflect the fair market value of the gas in question.

It is recognized that for one six months' period, July 1, 1972 to January 1, 1973, the rates paid were less than that shown on Stipulation No. 20, but in other periods of time the amounts paid exceeded the rates in Stipulation No. 20. Overall, for the entire time in question, plaintiffs have been paid an amount equal to or exceeding the rates stipulated to be the rates as fixed by the Federal Power Commission. There being no pleading to support any counterclaim by defendant against plaintiffs for any overpayment, no relief will be afforded defendant in this respect.

A judgment will this date be entered accordingly, and this supplemental memorandum opinion applies to each of the above cases.

Francia Goodwin Coe KINGERY,
Plaintiff-Appellee,
v.
CONTINENTAL OIL COMPANY,
Defendant-Appellant.

Lillian Blanche BRENT and Phillip Thompson,
Individually and as Trustees, Etc., et al.,
Plaintiffs-Appellants,
v.
NATURAL GAS PIPELINE COMPANY
of AMERICA, Defendant-Appellee.

J. M. HAWLEY, Independent Executor and
Trustee of the Estate of W. H. Taylor, deceased,
Plaintiff, Appellant,
v.
NATURAL GAS PIPELINE COMPANY
of AMERICA, Defendant-Appellee.

Nos. 78-1015, 78-3245 and 78-3246

United States Court of Appeals,
Fifth Circuit.
Oct. 2, 1980.

Royalty owners brought actions to recover alleged deficiencies from lessee producers of natural gas. The District Courts for the Northern and Western Districts of Texas, Halbert O. Woodward, Chief Judge, and William S. Sessions, J., 434 F.Supp. 349 and 457 F.Supp. 155, entered judgments, and appeals were taken. The Court of Appeals, Coleman, Chief Judge, held that only comparable sales that could be used in determining market value of gas sold in interstate commerce under certificates of convenience and necessity from Federal

Energy Regulatory Commission were sales on interstate market, even though lease was executed before passage of Natural Gas Act, where the gas was irrevocably dedicated to interstate market, and thus royalty owners were not entitled to award of deficiency under lease provision requiring that royalty payments be based upon market value of the gas

Two judgments reversed; one judgment affirmed.

Mines and Minerals 79.3

Only comparable sales that could be used in determining market value of gas sold in interstate commerce under certificate of convenience and necessity from Federal Energy Regulatory Commission were sales on interstate market, even though lease was executed before passage of Natural Gas Act, where the gas was irrevocably dedicated to interstate market, and thus royalty owners were not entitled to award of deficiency under lease provision requiring that royalty payments be based upon market value of the gas. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

W. B. Browder, Jr., Midland, Tex., Fred O. Hull, Houston Tex., for Continental Oil Co.

Earl A. Brown, Jr., pro se amicus curiae.

Frank G. Harmon, Baker & Botts, Stephen M. Hackerman, Houston, Tex., Leo Hoffman, Dallas, Tex., C. M. Hudspeth, Houston, Tex., Joe Harlan, Amarillo, Tex., E. R. Norwood, Liberty, Tex., Charles L. Black Aycock, Houston, Tex., for LaGloria Royalty Owners & Assn., Inc.,

Grambling, Mounce, Sims, Hardie, Galatzan &

Harris, John S. Birkelbach, William J. Mounce, El Paso, Tex., for Kingery.

Ronald D. Nickum, Howard F. Saunders, Amarillo, Tex., for Brent and Thompson, et al. and Hawley.

Robert Lee Bobbitt, Jr., San Antonio, Tex., for Sealy and Smith Foundation for the John Sealy Hospital.

H. A. Berry, Amarillo, Tex., Dennis Dylewski, John L. Verner, James T. Wright, Houston, Tex., for Natural Gas Pipeline Co. of America.

Appeals from the United States District Court for the Northern District of Texas.

Before COLEMAN, Chief Judge, and FRANK M. JOHNSON, Jr. and POLITZ, Circuit judges.

COLEMAN, Chief Judge.

These are three cases with rather similar facts, almost identical legal arguments, and diametrically opposing judicial results. We affirm No. 78-3245, *Brent v. Natural Gas Pipeline Company of America,* 457 F.Supp. 155, and No. 78-3246, *Hawley v. Natural Gas Pipeline Company of America.* We reverse No. 78-1015, *Kingery v. Continental Oil Company,* 434 F.Supp. 349.

In every case the plaintiffs are *royalty* interest owners under mineral leases covering land located in Texas. The defendants are lessee-producers. In every case the natural gas produced from the leasehold is transported and sold in interstate commerce under a certificate of convenience and necessity from the Federal Energy Regulatory Commission (FERC). This natural gas has been irrevocably dedicated to the interstate market. The natural gas and the sales thereof to interstate

purchasers have been subject to the regulation and control of the FERC, Natural Gas Act, 15, U.S.C. §§ 717 et seq. In each case the lease required the defendant-lessee to pay royalties based on the *market value of the gas*. In actual practice, the lessee paid the royalties based upon the sales price in the interstate market.

The royalty owners contend that the market value of the gas was greater than the interstate sales price. Suit was brought to recover alleged deficiencies in royalty payments for the four years previous to the date of filing the suit[1] but it must be noted that the royalty owners invariably accepted the royalty payments as tendered and never returned any of the payments received.

I. *The Brent and Hawley Cases*

In the first two cases, *Brent* and *Hawley*, the plaintiffs are the owners of the royalty payable under the gas leases covering land situated in Moore County, Texas. The leases were executed between 1926 and 1929 and were amended in 1934 and 1940, but the amendments are not involved in this dispute. The Natural Gas Pipeline Company of America is the natural gas producer under these leases and all of the gas produced is sold on the interstate market.

Each of the leases defined the amount of royalty to be paid as "the *market value* (emphases added) the well of one-eighth (⅛) of the gas produced, saved, and sold or used off the leased premises." Claiming that the *market* value of the gas was greater than the interstate *sales* price of the gas, the royalty owners sued to recover the alleged difference between the royalty actually paid and

[1] The parties agreed that Texas' four-year statute of limitations applies to these cases. Tex. Code. Ann. tit. 91, § 5527 (Vernon).

the royalty they would have received had the royalty been based on the market value of the gas, plus pre-judgment interest. The trial court found that the lease permitted interstate sales and that the mineral owners did not object when the lessee placed the gas in the interstate market.

In the proceeding below, owners' expert witnesses based their opinion concerning market value on both interstate and intrastate sales of gas during the time involved in this dispute. Because the sales price of natural gas on the uncontrolled intrastate market in Texas was higher than the sales price on the controlled interstate market, the market value of the gas in question, in the opinion of the owners' expert witnesses, was greater than the sales price received by the defendant-producer.

On the other hand, the defendant-producer's expert offered two alternative opinions as to market value. One of these opinions, based solely on interstate sales in the area, was that the market value of the gas was identical to the sales price received by the defendant-producer. The second opinion of market value was a weighted average of prices received for all gas sales, both intrastate and interstate, in the relevant geographical area during the applicable period of time.

The District Court held that the market value should be determined from evidence of recent sales of comparable gas on the interstate market. For this reason the trial court accepted the first stated opinion of the defendant-producer's expert, *i.e.*, that the market value and sales price were identical. The District Court went on to note that the market value was the same as the FERC price

ceiling in the area because all comparable gas in the area was being sold at the ceiling price. The Court then held that under the facts, the FERC price ceiling was the market value of the gas. Consequently, the District Court denied all relief sought by the royalty owners.

II. *The Kingery Case*

In the third case, the plaintiff, Kingery, owns an undivided one-half royalty interest under a mineral lease executed in 1944, encompassing land situated in Live Oak County, Texas. The defendant, Continental Oil Company, is the gas producer under this lease.

Pursuant to a contract entered into in 1949, the defendant-producer has sold this gas to Transcontinental Pipeline Corporation for transportation and resale in interstate commerce. By its terms, the contract would have expired no later than April 1, 1971, but in 1970 the defendant-producer and Transcontinental amended the contract and extended it until 1981.

The trial court found as a matter of fact that between 1949 and 1970 the only market for the gas produced from the lease and for gas of like quantity and quality in the area was the interstate market. The Court found, however, that from 1972 until the present, the intrastate market had been available. The lease provided that the lessee had the obligation "to use all reasonable efforts to find a market . . . and to commence or resume the marketing . . . when a market [is] available." The trial court found that the Transcontinental Pipeline contract which dedicated the gas to interstate commerce was reasonable.

The gas royalty provision of the lease stated:

> 3. The royalties to be paid by Lessee are: . . . (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.

Claiming that the gas had been sold off the premises and that the market value of the gas exceeded the sales price under the contract with Transcontinental, the royalty owner sued in 1976 to recover the alleged difference between the royalty she had actually received and the amount of royalty she would have received had the royalty been based on the market value of the gas.

In the trial below the royalty owner's expert witnesses based their opinion as to the market value of the gas *solely on area sales of comparable gas in the intrastate market.* Making no distinction between the interstate and intrastate markets, the District Court held that market value was to be established by evidence of gas sales and contract negotiations for gas sales in the immediate area during the relevant years. The Court, therefore, accepted the opinion of the royalty owner's experts as to market value and awarded the plaintiff-owner $323,592.30 in unpaid royalties. The defendant-producer appealed.

III. *Analysis*

The controlling question[2] in each of these cases is the

[2] The various appellants raise a number of other issues which we need not reach because of our disposition of these cases based on this controlling issue.

same: How is the market value of this natural gas to be determined?

The royalty owners essentially argue that market value is to be gleaned from all sales of comparable gas in the geographical area during the period in question on both the interstate and intrastate markets. They point out that this approach reflects the traditional willing-buyer, willing-seller standard. On the other side, the defendant-producers contend that in determining market value, only sales on the interstate market should be considered because the gas has been irrevocably dedicated to interstate commerce.

The standard test for determining the market value of gas sold on the interstate market is

> [W]hat would a willing seller and a willing buyer in a business which subjects them and the commodity to restriction and regulation, including a commitment for a long period of time, agree to take and pay with a reasonable expectation that the FPC [now the FERC] would approve the price (and price changes) and other terms and then issue the necessary certificate of public convenience and necessity.

Weymouth v. Colorado Interstate Gas Company, 367 F.2d 84, 90 (5 Cir. 1966).[3] The Supreme Court of Texas has said that the market value of the "gas is to be determined by sales of gas comparable in time, quality and availability to marketing outlets," citing *Phillips*

[3] The plaintiff-owners argue that this test has been overruled, at least by implication, in *Mobile Oil Corp. v. Federal Power Commission*, 463 F.2d 256 (D.C. Cir. 1971). *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676. We disagree. This decision had little to do with the actual determination of the market value of interstate gas. It simply held that the FERC (then the FPC) lacked the authority to regulate the amount of royalty paid and that the FERC price ceiling in the area did not necessarily determine the market value of the gas.

Petroleum Co. v. Bynum, 155 F.2d 196 (5 Cir. 1946). *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 872 (Tex.Sup.Ct. 1968). However, *Vela* was not concerned with gas which had been dedicated to interstate commerce.

In light of this test, to determine the market value of the gas in question the Court must decide which gas sales are comparable, given the ineluctable fact that this gas has been irrevocably dedicated to interstate commerce and the price is subject to regulation. We are of the opinion that where the gas has been irrevocably dedicated to the interstate market, it follows inexorably that the only comparable sales to be used in determining the market value of such gas are sales on the interstate market. It likewise follows that sales on the intrastate market are not comparable in determining the market value of such gas. *Hemus & Company v. Hawkins*, 452 F.Supp. 861 (S.D.Tex. 1978).

The royalty owners strongly argue that this conclusion is precluded by the decisions in *Texas Oil & Gas Co. v. Vela*, 429 S.W.2d 866 (Tex.Sup.Ct. 1968) and *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5 Cir. 1966).

As noted *ante*, *Vela*, involved the determination of the market value of intrastate gas committed to a long-term contract. In that case the Texas Supreme Court held that a lessee could not escape its duty to pay royalties based on the market value of the gas because of its failure to protect itself from rising prices. The decision did not directly deal with interstate gas and, therefore, is not here in point. As the Houston Court of Civil Appeals has stated:

> We do not believe that the Texas courts will apply

> the principles of *Vela* to federally controlled or regulated interstate gas, since there can be no "market value" or "market price" in a price-regulated environment, although we recognize that the supreme court did permit the consideration in *Vela* of the price of regulated gas sold to Tennessee from the Lopeno Field.

Exxon Corp. v. Middleton, 571 S.W.2d 349, 362, n. 3 (Tex.Civ.App. — Houston [14th] 1978), writ granted.

In *J. M. Huber Corp. v. Denman, supra*, the Court stated the controlling issue as:

> [W]hether under the terms of the oil and gas lease from Lessors to Lessee-Producer the amount payable as royalty is to be fixed by the stated percentage (¼th of (a) the price received by the Lessee from its Pipeline Purchaser or (b) the market price for like gas in the field.

Id. at 106. The Court held that the lease required the lessee to pay one-fourth of the market value of the gas instead of one-fourth of the sales price. The Court then noted that the sales price fixed by the pre-existent contract with the pipeline company was not necessarily the market value of the gas; but the Court left the question of market value *to be resolved later.*

Huber is not inconsistent with the results we reach in the present cases because we do not hold that the sales price of the gas in question automatically determines its market value; instead we hold only that the market value of *interstate* gas is to be determined by comparison with the sales of comparable gas on the interstate market. This is so because this gas could not be sold on the intra-state market and thus its value on that market was zero. See *Phillips Petroleum Co. v. Ochsner*, 146 F.2d 138 (5 Cir. 1944). Since sellers and buyers of gas in interstate

commerce cannot lawfully contract for a price above that allowed by federal regulations, prices above that figure are simply not comparable. This is as far as we need go to decide the cases before us and that is as far as we do go.

The plaintiff-owners argue that the various parties to the leases under consideration never contemplated that the amount of royalty would later be affected by FERC price regulations and that, therefore, FERC regulations cannot alter the rights of the parties under the lease. They point out that the leases were executed before the passage of the Natural Gas Act and the decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954) which held that the FERC had the authority to regulate the sales price of natural gas on the interstate market.

We believe that the Supreme Court has rejected this argument in *California v. Southland Royalty Co.*, 436 U.S. 519, 98 S.Ct. 1955, 56 L.Ed.2d 505 (1978). There, in 1925, before the FERC began regulating the price of gas on the interstate market, the plaintiff-owners executed a mineral lease allowing the defendant-producer to sell the gas on the interstate market. Later in 1951 the plaintiff-owners did not object when the defendant-producer contracted to sell the gas to an interstate pipeline. Also, the plaintiff-owners did not object when, after *Phillips*, the defendant-producer sought and received a certificate of convenience and necessity of unlimited duration.

After the lease expired in 1975 the plaintiff-owners attempted to withdraw the gas from interstate commerce in order to sell it on the intrastate market. The FERC (then the FPC) determined that gas once dedicated to the

interstate market could not be withdrawn therefrom without FERC authorization. In sustaining this determination the Supreme Court stated in language equally applicable to the present cases:

> In any event, we perceive no unfairness in holding . . . lessors responsible for continuation of the services until abandonment is obtained . . . Having authorized Gulf [defendant-producer] to make interstate sales of gas, respondents could not have expected those sales to be free from the rules and restrictions that from time to time would cover the interstate market. Cf. *Louisville & Nashville R. Co. v. Mottley*, 219 U.S. 467, 482 [31 S.Ct. 265, 270, 55 L.Ed. 297] (1911).

Id. at 528-529, 98 S.Ct. at 1960.

In *Brent* and *Hawley* the District Court based its opinion concerning the market value of the gas in question on the sales of comparable gas in the interstate market, the only place where the gas could be sold. We are unable to say that this was error. We, therefore, affirm the judgment of the District Court.

In *Kingery* the royalty owner's only evidence of market value concerned gas sales on the intrastate market; therefore, on the rationale hereinabove set out, the District Court's finding as to market value in that case must be held to be clearly erroneous. We must reverse this finding and the judgment predicated upon it.

The Judgments is No. 78-3245 and No. 78-3246 are AFFIRMED.

The Judgment in No. 78-1015 is REVERSED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 78-3245

Lillian Blanche BRENT and Phillip THOMPSON,
Individually and as Trustees, Etc., Et Al.,
Plaintiffs-Appellants

vs.

NATURAL GAS PIPELINE COMPANY
OF AMERICA, Defendant-Appellee.

NO. 78-3246

J. M. HAWLEY, Independent Executor and
Trustee of the Estate of W. H. Taylor, deceased,
Plaintiff-Appellant,

vs.

NATURAL GAS PIPELINE COMPANY
OF AMERICA, Defendant-Appellee.

Appeals from the United States District Court for the
Northern District of Texas

On Petition for Rehearing
and Petition for Rehearing En Banc

(Opinion 10-2-80, 5 Cirt., 197__, ___ F.2d __).

(July 23, 1981)

Before COLEMAN, FRANK M. JOHNSON, JR. and POLITZ, Circuit Judges.

PER CURIAM:

(X) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16) the Petition for Rehearing En Banc is DENIED.

( ) The Petition for Rehearing is DENIED and the Court having been polled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16) the Petition for Rehearing En Banc is also DENIED.

( ) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT:

Jas. P. Coleman
United States Circuit Judge

Form 704-2

Opposition

DEC 4 1981

ALEXANDER L. STEVAS
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-893

LILLIAN BLANCHE BRENT AND PHILLIP THOMPSON, Individually and as Trustees of the Mrs. Georgie Thompson Trust No. 1 (created by the will of Georgie E. Thompson, deceased);
FRANCES DIANE NEAL AND THE AMERICAN NATIONAL BANK, Independent Executors of the Estate of Terry Thompson, Jr.;
ROBERT PRICE BRENT, III AND PHILLIP THOMPSON, as Trustees for the Terry Thompson Children's Trust and the Terry Thompson Grandchildren's Trust,

Petitioners,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Respondent,

and

J. M. HAWLEY, Independent Executor and Trustee of the Estate of W. H. Taylor, Deceased,

Petitioner,

v.

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Respondent.

BRIEF IN OPPOSITION TO CONSOLIDATED PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

DENNIS M. DYLEWSKI
JOHN L. VERNER
CALVIN, DYLEWSKI, GIBBS, MADDOX & RUSSELL
P.O. Box 61586
Houston, Texas 77208

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-893

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NATURAL GAS PIPELINE COMPANY OF AMERICA,

Respondent,

and

J. M. HAWLEY, Independent Executor and Trustee of the Estate of W. H. Taylor, Deceased,

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NATURAL GAS PIPELINE COMPANY OF AMERICA,

Respondent.

BRIEF IN OPPOSITION TO CONSOLIDATED PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To The Honorable Chief Justice And Associate Justices Of The Supreme Court Of The United States:

The Respondent, Natural Gas Pipeline Company of America, ("Natural"), respectfully files this its Brief In Opposition to the Consolidated Petition For Writ of Certiorari to the United States Court of Appeals For the Fifth Circuit filed in this cause by the Petitioners, Lillian Blanche Brent, et al, and J. M. Hawley, Independent Executor.

REASONS FOR DENYING THE WRIT

1. The Supreme Court of the State of Texas has expressly stated that the decision below is in accord with its own decisions. There is, therefore, no conflict between the decision of the Fifth Circuit Court of Appeals and Texas law.

2. The substance of the decision below is entirely harmonious with similar decisions rendered by the Supreme Court of the State of Texas.

3. Federal interstate gas prices utilized below represent stipulations and factual determinations not to be disturbed on appeal.

The Texas Supreme Court Has Noted the Accordance of the Decision Below With State Law

The Petitioners have based their petition for Writ of Certiorari squarely upon an assertion that the decision below conflicts with decisions of the highest Court in the State of Texas on exactly the same point. The Texas Supreme Court opinions which are alleged to conflict with the Fifth Circuit decision under review are *Exxon Corporation* v. *Middleton*, 613 S.W.2d 240 (Tex. 1981), and *First National Bank in Weatherford* v. *Exxon Corporation*, ... S.W.2d ...., 24 Tx. Sup. Ct. Jrnl. 499 (Tex. 1981).

The Texas Supreme Court's *Weatherford* opinion incorporates the salient portion of its writing in *Middleton*, and the very first paragraph of the *Weatherford* opinion makes open

reference to the case at bar. The instant case was reported by the Fifth Circuit under the style of *Kingery* v. *Continental Oil Co.*, 626 F.2d 1261 (5th Cir. 1980). In the fourth sentence of its opinion, the Texas Supreme Court noted that it was granting review of the case because "several other cases are pending involving the same or related questions", at which point the Court referred to a footnote containing the following text:

> 1./ See *e.g.*, *Kingery* v. *Continental Oil Co.*, 626 f.2d 1261 (5th Cir. 1980). *The Fifth Circuit reached the same result we here reach.* We are told by counsel in our case, that the Fifth Circuit is withholding its action upon the motion for rehearing in Kingery to await our decision in this case.

24 Tx. Sup. Ct. Jrnl. at 499 (emphasis added).

Natural agrees with the Petitioners that it was incumbent upon the Fifth Circuit in the instant case to apply Texas law as best it could divine it. According to the Texas Supreme Court in its *Weatherford* footnote, the Fifth Circuit's divination was perfect. While this Court certainly has Certiorari jurisdiction to resolve conflicts between Federal and State decisions, no Court is better situated to detect such a conflict with Texas law than the Texas Supreme Court. That Court has expressly stated that the decision below is *"the same"* as its own decision on the same point. When the ultimate judge of State law specifically reviews a Federal diversity opinion and detects no conflict between it and the law of its own State, there is little room for review even in this honorable Court.

As an additional consideration, it is apparently a fact that the Fifth Circuit took special consideration in the instant case to avoid any conflict with Texas law. The *Kingery* opinion was delivered on October 2, 1980, but the Court delayed action on Motions for Rehearing (as noted in *Weatherford*) until the Texas Supreme Court announced its determination in

Weatherford on July 15, 1981. Eight days later, the Fifth Circuit denied pending motions and finalized its opinion in reliance upon the Texas Supreme Court.

The Decision Below is Fully Harmonious With Texas Law

Even if this Court were to disregard the Texas Supreme Court's own recognition of the accord between the decision below and Texas law, their consistency is easily demonstrable. Both the Texas Supreme Court and the Fifth Circuit Court of Appeals have based their opinions upon the straightforward proposition that the market value of natural gas cannot be represented by prices which simply cannot be obtained for the gas at issue. In a broad sense, this proposition means that unregulated intrastate gas prices cannot be utilized to prove the market value of regulated interstate gas. In a more narrow sense, the same proposition means that interstate prices which might apply to one category of interstate gas cannot be utilized to prove the market value of interstate gas which belongs to a separate category with a separate price structure. The exclusion of inapplicable interstate rates is a logical extension of the exclusion of inapplicable intrastate prices, as recognized by both State and Federal Courts.

The Court below realized that a particular FERC price ceiling applied to the gas at issue, and noted that the District Court had held

> that the market value was the same as the FERC price ceiling in the area because all comparable gas in the area was being sold at the ceiling price.

626 F.2d at 1263; Petitioners' Brief at A-27. The Fifth Circuit went on to hold as follows:

> we do not hold that the sales price of the gas in question automatically determines its market value; instead we hold only that the market value of *interstate* gas is to be determined by comparison with the sales of comparable gas

> on the interstate market . . . . *Since sellers and buyers of gas in interstate commerce cannot lawfully contract for a price above that allowed by Federal regulations, prices above that figure are simply not comparable.*

626 F.2d at 1265; Petitioners' Brief at A-32 (emphasis added).

The Texas Supreme Court has specifically recognized the importance of price categories in both its *Weatherford* and *Middleton* opinions. As noted above, the salient portions of *Middleton* were incorporated in *Weatherford*, wherein the Court stated that the question of how the market value of gas is to be determined was answered in its earlier opinion. The Court's quotation from *Middleton* included the following language, portions of which are omitted in the Petitioners' argument:

> Market value may be calculated by using comparable sales. Comparable sales of gas are those comparable in time, quality, quantity and availability of marketing outlets.
>
> . . . Sales comparable in quality . . . also involves the legal characteristics of the gas; that is, whether it is sold in a regulated or unregulated market, or in *one particular category of a regulated market.*

24 Tex. Sup. Ct. Jrnl. at 500, quoting from 613 S.W.2d at 247, (emphasis added).

The Texas Supreme Court's recognition of the importance of separate price categories may be underscored by reference to the Court of Civil Appeals decision which was under review in *Weatherford*. In its own opinion, the El Paso Court of Civil Appeals had noted that the FERC

> classifies and divides the gas into various categories and fixes the price for each category. With all prices fixed, we fail to see how one could be comparable to the other to make either the "market value".

597 S.W. at 786. This notation by the Court was fully in accordance with its observation in the same case that "Evidence of a price arrived at above the Federally regulated price would not be admissible as a comparable." 597 S.W. 2d at 786.

The Texas Supreme Court had ample opportunity in *Weatherford* to comment upon the Petitioners' argument before this Court that specific FERC price ceilings do not define the market value of interstate gas under Texas law. The following is an excerpt from the First National Bank's Application For Writ of Error in *Weatherford*, wherein the Bank urged the same point urged by the Petitioners here:

POINT 11

THE COURTS BELOW ERRED IN FINDING THAT A SALE OF GAS WHICH COULD BE SOLD ON THE INTERSTATE MARKET FOR A HIGHER CEILING PRICE THAN THAT APPLICABLE TO THE GAS INVOLVED IN THIS CASE IS NOT, FOR THE PURPOSES OF ASCERTAINING THE ROYALTY DUE, COMPARABLE TO THE SALE OF GAS FROM THE BANK'S LEASE. (Germane to Point XI, Motion for Rehearing).

The Texas Supreme Court did not grant review upon the Bank's Point 11. *See*, 24 Tex. Sup. Ct. Jrnl. 375, 376 (Tex. 1981).

Any differences between the decision below and those of the Texas Supreme Court are purely the result of different factual contexts. The governing principles of law in the comparative decisions are precisely the same: unobtainable prices in either the intrastate or interstate markets do not define the market value of interstate gas subject to specific price regulations. There exists no conflict between the decision below and Texas law as enunciated by the highest Court of the State.

Interstate Gas Prices Were Correctly Applied by The Court Below

As a secondary reason for the grant of a Writ of Certiorari, the Petitioners assert that the Fifth Circuit Court of Appeals utilized erroneous Federal interstate gas rates in determining the market value of the gas at issue. The findings of the Amarillo District Court, which were accepted by the Fifth Circuit, should

not be disturbed by this Court inasmuch as the Petitioners are urging a revision of a factual determination which they introduced no trial evidence to refute. Moreover, the rates applied by the District Court were the product of joint stipulations by the parties which were duly offered into evidence at trial.

Natural conclusively proved the market value of the gas at issue during the trial of this cause through its expert witness, Mr. Jack Baumel. The Trial Court accepted the testimony of Mr. Baumel and, as noted by the Fifth Circuit, found that all comparable gas in the relevant market area was being sold at certain Federal area price ceilings. Although the Petitioners claim that incorrect price ceilings were utilized at trial, they point to no evidence in the record to support the utilization of their preferred rate structure.

Contrary to their position before this Court, the Petitioners were in total agreement with Natural during the trial of this cause as to the Federal rate structure applicable to the gas at issue. The rates used by the Courts below arose out of stipulations entered into by the parties in order to shorten and simplify the trial of this cause. The text of the stipulation at issue herein can be found in *Brent* R.O.A. p. 241 and *Hawley* R.O.A. p. 182, and provides as follows:

> It is stipulated that the area rates established by the Federal Power Commission applicable to the area in which gas produced from the leases herein was produced have been as follows:
>
> July 1, 1971 to July 1, 1972, 13.5c per mcf
> July 1, 1972 to Jan. 1, 1976, 14.5c per mcf
> Jan. 1, 1976 to July 1976, 23.5c per mcf
> July 1, 1976 to date of this stipulation 29.5c per mcf.

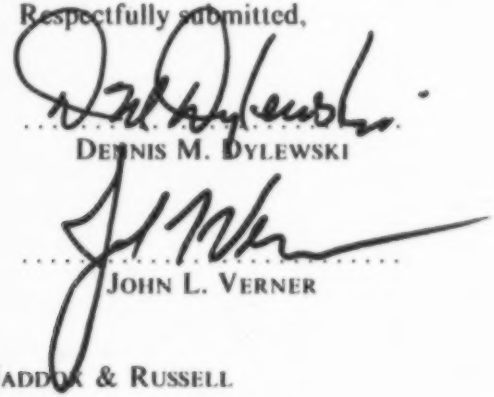
As can be seen from the stipulation, the parties did not merely agree that Natural had paid royalties based upon the quoted rates; rather, it was specifically agreed that these rates *were the*

applicable rates for the gas at issue. The parties having agreed on the applicable rates and there being no evidence in the record to premise the application of any other rates, the finding of the Courts below should be left undisturbed.

CONCLUSION

For the foregoing reasons, this Honorable Court should Deny a Writ of Certiorari in this cause.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I, Dennis M. Dylewski, hereby certify that a true and correct copy of the foregoing Brief in Opposition To Consolidated Petition For Writ of Certiorari To The United States Court of Appeals for the Fifth Circuit was forwarded by express courier to Mr. Ronald D. Nickum of Sanders, Saunders, Brian, Finney, Thomas & Smith, P.O. Box 9317, Amarillo, Texas, 79105 on this 2nd day of December, 1981.

DENNIS M. DYLEWSKI